

## Message Text

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PAGE 01 BONN 03841 01 OF 04 071454Z

47

ACTION EUR-12

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LIMITED OFFICIAL USE SECTION 01 OF 04 BONN 03841

PASS TREASURY FOR ASSISTANT SECRETARY HICKMAN

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TAGS: EFIN, GW

SUBJECT: GERMAN CORPORATE TAX REFORM

1. SUMMARY. THE GERMAN PARLIAMENT WILL BEGIN HEARINGS ON THE FEDERAL GOVERNMENT'S CORPORATE TAX REFORM PROPOSAL AFTER EASTER. THE REFORM WILL INCREASE THE TAXATION OF US COMPANIES IN THE FEDERAL REPUBLIC. THE FEDERAL GOVERNMENT PLANS TO APPROACH THE US IN THIS CONNECTION IN MAY WITH A REQUEST FOR ELIMINATING FROM THE US GERMAN DOUBLE TAXATION CONVENTION THE 15 PERCENT LIMITATION ON GERMAN TAXATION OF REPATRIATED EARNINGS OF US DAUGHTER COMPANIES. CHANCELLOR SCHMIDT REPORTEDLY IS TAKING A PERSONAL INTEREST IN THIS MATTER AND MAY HIMSELF APPROACH US OFFICIALS ON THIS QUESTION. END SUMMARY.

A. GERMAN CORPORATE TAX REFORM AND THE US/GERMAN DOUBLE TAXATION CONVENTION

2. FINANCE MINISTRY PARLIAMENTARY STATE SECRETARY  
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PAGE 02 BONN 03841 01 OF 04 071454Z

OFFERGELD HAS TOLD US THAT HEARINGS WILL START AFTER

EASER IN THE FINANCE COMMITTEE OF THE BUNDESTAG ON THE GOVERNMENT'S CORPORATE TAX REFORM BILL. ACCORDING TO OFFERGELD THE BILL HAS THE STRONG SUPPORT OF THE FDP, SUPPORT FROM THE CDU AND IS "TOLERATED" BY THE SPD AS PART OF ITS AGREEMENTS WITH ITS COALITION PARTNER. OFFERGELD EXPECTS PARLIAMENTARY PASSAGE WITHOUT ANY SIGNIFICANT CHANGE FROM THE PRESENT GOVERNMENT DRAFT.

3. OFFERGELD INDICATED THAT THE FEDERAL GOVERNMENT CONTINUES TO BELIEVE THAT AS PART OF THE TAX REFORM PACKAGE, AGREEMENT SHOULD BE REACHED WITH THE US TO A CHANGE IN THE US/GERMAN DOUBLE TAXATION CONVENTION ELIMINATING THE 15 PERCENT LIMITATION ON GERMAN WITHHOLDING TAXES ON DIVIDENDS REPATRIATED BY US DAUGHTER COMPANIES TO THE UNITED STATES SO THAT SUCH DIVIDENDS COULD BECOME SUBJECT TO A 25 PERCENT WITHHOLDING TAX. OFFERGELD INDICATED THAT WE COULD EXPECT THE FRG TO RAISE THIS QUESTION WITH US PROBABLY IN MAY AND THAT CHANCELLOR SCHMIDT WAS TAKING A PERSONAL INTEREST IN THIS MATTER AND MIGHT WELL PERSONALLY BRING UP THE QUESTION WITH US OFFICIALS.

4. AS WASHINGTON AGENCIES ARE AWARE, THE GERMAN FINANCE MINISTRY HAS FOR MANY YEARS WISHED TO ELIMINATE THE SPECIAL 15 PERCENT WITHHOLDING RATE ON DIVIDENDS REPATRIATED BY US DAUGHTER COMPANIES TO THE US (WITHOUT EVER INDICATING A WILLINGNESS TO ALSO WAVE THE 15 PERCENT LIMITATION ON US TAX OF DIVIDENDS REPATRIATED BY GERMAN DAUGHTER COMPANIES FROM THE US). THE BASIC GERMAN ARGUMENT HAS BEEN THAT THE SPECIAL 15 PERCENT WITHHOLDING RATE GIVES US COMPANIES TOO GREAT AN ADVANTAGE OVER THEIR GERMAN COMPETITORS IN VIEW OF GERMANY'S LOWER CORPORATE TAX RATE ON DISTRIBUTED EARNINGS AND THE POSSIBILITY OF US COMPANIES TAKING ADVANTAGE OF THIS BY REPATRIATING EARNINGS AND THEN SUBSEQUENTLY REINVESTING THEM IN THEIR GERMAN DAUGHTERS AND THUS AVOIDING THE HIGHER GERMAN TAX ON RETAINED EARNINGS. IN THEORY THIS IS TO BE PREVENTED (OR AT LEAST AMELIORATED) BY AN ADDITIONAL 10 PERCENT LIMITED OFFICIAL USE

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PAGE 03 BONN 03841 01 OF 04 071454Z

TAX LEVIED WHEN A US COMPANY REINVESTS FUNDS IN A DAUGHTER IN GERMANY WHICH PREVIOUSLY HAD BEEN REPATRIATED BY THAT DAUGHTER AND BEEN SUBJECT ONLY TO THE PREFERENTIAL 15 PERCENT GERMAN WITHHOLDING TAX. THE GERMAN AUTHORITIES ARGUE, HOWEVER, THAT SINCE FUNDS ARE FUNGIBLE, IT IS VERY DIFFICULT IN PRACTICE TO ESTABLISH THE LINK BETWEEN A NEW INVESTMENT AND PREVIOUSLY REPATRIATED PROFITS AND THE SPECIAL 10

PERCENT TAX THEREFORE IS LARGELY AVOIDED. MAINLY ON THESE GROUNDS THEY THEREFORE WANT TO ABOLISH THE PREFERENTIAL 15 PERCENT WITHHOLDING RATE ON REPATRIATED EARNINGS AND ARE SEEKING US CONCURRENCE TO A CHANGE TO THIS EFFECT IN OUR DOUBLE TAXATION CONVENTION.

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PAGE 01 BONN 03841 02 OF 04 071500Z

47

ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 TRSE-00 XMB-02 OPIC-03 SP-02 CIEP-01

LAB-04 SIL-01 OMB-01 NSC-05 SS-15 STR-01 CEA-01 L-02

H-02 PA-01 PRS-01 USIA-06 /083 W

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FM AMEMBASSY BONN

TO SECSTATE WASHDC 8533

LIMITED OFFICIAL USE SECTION 02 OF 04 BONN 03841

5. AS WASHINGTON AGENCIES ARE ALSO AWARE THE ORIGINAL GERMAN GOVERNMENT CORPORATE INCOME TAX REFORM DRAFT LAW PROPOSED THE COMPLETE ABOLITION OF THE LOWER TAX RATE FOR DISTRIBUTED DIVIDENDS AND INSTEAD SUBSTITUTED A UNIFORM 56 PERCENT CORPORATE TAX RATE WITH A FULL CREDIT ON GERMAN INDIVIDUAL INCOME TAXES FOR CORPORATE INCOME TAX PAID ON DISTRIBUTED DIVIDENDS. FOREIGN TAXPAYERS NOT SUBJECT TO GERMAN INDIVIDUAL INCOME TAXES WOULD NOT HAVE RECEIVED THE TAX CREDIT AND THEIR GERMAN TAXATION THEREFORE WOULD HAVE INCREASED VERY SUBSTANTIALLY. FOR A NUMBER OF REASONS, INCLUDING THE HARDSHIP ON FOREIGN DAUGHTER COMPANIES IN THE FRG, THE GERMAN GOVERNMENT SUBSEQUENTLY CHANGED ITS DRAFT LAW

TO PROVIDE FOR A SPLIT RATE OF 56 PERCENT ON RETAINED EARNINGS AND 36 PERCENT ON DISTRIBUTED PROFITS, WITH THE TAX ON DISTRIBUTED PROFITS FULLY CREDITABLE AGAINST GERMAN PERSONAL INCOME TAXES. AT THE TIME THE FINANCE MINISTRY TOLD US THAT THE NEW PROPOSAL-- WHICH CONSTITUTED A SIGNIFICANT IMPROVEMENT FOR US DAUGHTER COMPANIES OVER THE EARLIER DRAFT (BUT NOT THE LIMITED OFFICIAL USE

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PAGE 02 BONN 03841 02 OF 04 071500Z

CURRENT SYSTEM) WOULD NOT BE POLITICALLY ACCEPTABLE TO GERMAN INDUSTRY (WHICH INSISTS ON AN ABOLITION OF THE SUPPOSEDLY PRIVILEGED TAX POSITION OF FOREIGN DAUGHTER COMPANIES) UNLESS IT WERE ACCOMPANIED BY AN ABOLITION OF THE SPECIAL 15 PERCENT WITHHOLDING TAX RATE ON REPATRIATED EARNINGS UNDER THE US/GERMAN DOUBLE TAXATION CONVENTION. OFFERGELD CONDUCTED DISCUSSIONS WITH US TREASURY OFFICIALS ON THIS QUESTION IN JUNE OF 1972 AND TELLS US THAT WHILE HE RECEIVED NO COMMITMENTS HE CAME AWAY WITH THE IMPRESSION THAT THE US HAD AN OPEN MIND ON THIS QUESTION. THE GERMAN CORPORATE TAX REFORM SUBSEQUENTLY WAS STALLED AND PARLIAMENTARY DISCUSSION IS ONLY NOW RESUMING AND WITH IT THE GERMANS WANTS TO TAKE UP WITH US AGAIN THE DOUBLE TAXATION CONVENTION QUESTION. OFFERGELD SAYS THAT THE PRESENT 15 PERCENT SPECIAL RATE IS "INTOLERABLE" FOR THE FRG.

B. TAXATION OF GERMAN COMPANIES AND US DAUGHTER COMPANIES UNDER THE PRESENT GERMAN CORPORATE INCOME TAX

6. PRESENTLY A GERMAN COMPANY PAYS THE FOLLOWING TAXES ON A GROSS PROFIT OF DM 100 IF ALL OF IT IS RETAINED AND REINVESTED IN THE COMPANY: A 13 PERCENT (DM 13) INCOME TAX ELEMENT OF THE GERMAN TRADE TAX, LEAVING A DM 87 OF AFTER TRADE TAX PROFITS ON WHICH IT PAYS THE 52 PERCENT (DM 45) CORPORATE INCOME TAX. THE NET AFTER TAX PROFIT RETAINED IN THE COMPANY THUS AMOUNTS TO DM 42.

7. A US DAUGHTER, ON THE OTHER HAND, PAYS THE FOLLOWING TAXES ON A DM 100 PROFIT WHOLLY REINVESTED IN THE FIRM: A 13 PERCENT GERMAN TRADE TAX, LEAVING DM 87 ON WHICH IT PAYS THE 23 PERCENT (OR DM 20) GERMAN CORPORATE INCOME TAX ON DISTRIBUTED PROFITS. THIS LEAVES IT WITH DM 67 WHICH ARE SUBJECT TO A 15 PERCENT (DM 10) GERMAN WITHHOLDING TAX AND AN ADDITIONAL 10 PERCENT (DM 7) TAX IF THEY ARE SUBSEQUENTLY TO BE REINVESTED IN THE GERMAN DAUGHTER. IT THUS IS ABLE TO REPATRIATE DM 50 OF THE ORIGINAL DM 100 PROFIT TO THE US WHERE IT BECOMES SUBJECT TO

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PAGE 03 BONN 03841 02 OF 04 071500Z

THE 48 PERCENT US CORPORATE INCOME TAX. SINCE, HOWEVER, DM 50 OF GERMAN TAXES ARE CREDITABLE AGAINST THE US TAX, NO ADDITIONAL TAX IS PAYABLE AND THE FIRM CAN REINVEST THE WHOLE DM 50 IN ITS GERMAN DAUGHTER.

8. THE US DAUGHTER THUS HAS A TAX ADVANTAGE OVER A GERMAN COMPANY OF 8 PERCENTAGE POINTS ON THE TOTAL TAXATION OF RETAINED/REINVESTED EARNINGS. THIS TAX ADVANTAGE INCREASES TO 10 PERCENTAGE POINTS IF THE US DAUGHTER AVOIDS THE ADDITIONAL 10 PERCENT GERMAN TAX ON REPATRIATED AND SUBSEQUENTLY REINVESTED PROFITS (ITS GERMAN TAXES IN THAT CASE WOULD AMOUNT TO DM 43, BUT IT WOULD HAVE TO PAY DM 5 ADDITIONAL US CORPORATE INCOME TAX).

9. THE SITUATION IS REVERSED ON DISTRIBUTED, NON-REINVESTED EARNINGS. IN THIS CASE THE GERMAN FIRM PAYS THE 13 PERCENT (DM 13) TRADE TAX ON A DM 100 PROFIT. THE REMAINING DM 87 ARE SUBJECT TO THE 23 PERCENT (DM 20) CORPORATE INCOME TAX ON DISTRIBUTED EARNINGS. THE SHAREHOLDERS THUS RECEIVE DM 67 (OF

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PAGE 01 BONN 03841 03 OF 04 071503Z

47

ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 TRSE-00 XMB-02 OPIC-03 SP-02 CIEP-01

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H-02 PA-01 PRS-01 USIA-06 /083 W

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FM AMEMBASSY BONN  
TO SECSTATE WASHDC 8534

LIMITED OFFICIAL USE SECTION 03 OF 04 BONN 03841

WHICH A FURTHER PART HAS BEEN WITHHELD BUT IS FULLY  
CREDITABLE AGAINST GERMAN INDIVIDUAL INCOME TAX).

10. THE US DAUGHTER ALSO PAYS THE GERMAN TRADE TAX  
AND CORPORATE INCOME TAX ON DISTRIBUTED EARNINGS. OUT  
OF DM 100 OF EARNINGS, DM 67 REMAIN AFTER THESE TAXES.  
THE DM 67 ARE SUBJECT TO THE GERMAN 15 PERCENT (DM 10)  
WITHHOLDING TAX SO THAT DM 57 CAN BE REPATRIATED TO  
THE US WHERE THE WHOLE DM 100 ARE SUBJECT TO THE  
48 PERCENT US CORPORATE INCOME TAX WITH THE 43 PERCENT  
OF GERMAN TAXES ALREADY PAID CREDITED AGAINST THE US  
TAX. ON DISTRIBUTED EARNINGS A GERMAN COMPANY THUS  
PAYS 10 PERCENTAGE POINTS LESS OF NON-REFUNDABLE  
GERMAN TAXES AND 15 PERCENTAGE POINTS LESS THAN THE  
COMBINED GERMAN AND US TAX PAYMENT OF THE US COMPANY.

C. TAXATION OF GERMAN AND US DAUGHTER COMPANIES  
UNDER THE PROPOSED NEW GERMAN CORPORATE INCOME TAX

11. UNDER THE PROPOSED LEGISLATION A GERMAN COMPANY  
WOULD PAY THE FOLLOWING TAXES ON DM 100 OF RETAINED  
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PAGE 02 BONN 03841 03 OF 04 071503Z

EARNINGS: THE 13 PERCENT (DM 13) TRADE TAX AND A  
56 PERCENT (DM 49) CORPORATE INCOME TAX ON THE  
REMAINING PROFIT, LEAVING DM 38 TO BE RETAINED IN  
THE COMPANY.

12. A US DAUGHTER WOULD PAY THE FOLLOWING TAXES ON  
DM 100 OF REPATRIATED AND SUBSEQUENTLY REINVESTED  
EARNINGS: THE 13 PERCENT (DM 13) GERMAN TRADE TAX,  
LEAVING DM 87 SUBJECT TO THE 36 PERCENT (DM 31) GERMAN  
CORPORATE INCOME TAX ON DISTRIBUTED EARNINGS, LEAVING  
DM 56 SUBJECT TO THE 15 PERCENT (DM 8) WITHHOLDING TAX  
AND THE 10 PERCENT (DM 6) ADDITIONAL WITHHOLDING TAX  
FOR SUBSEQUENTLY REINVESTED EARNINGS. THE TOTAL GERMAN  
TAX BURDEN THUS WILL BE 58 PERCENT AND NO ADDITIONAL  
US CORPORATE INCOME TAX WILL BE PAYABLE. OUT OF THE  
DM 100 THE COMPANY CAN REINVEST DM 42 IN ITS GERMAN  
DAUGHTER.

13. THE PROPOSED NEW GERMAN CORPORATE INCOME TAX THUS

CUTS IN HALF THE TAX ADVANTAGE OF US DAUGHTER COMPANIES OVER GERMAN COMPANIES ON RETAINED/REINVESTED EARNINGS. BUT IT STILL LEAVES THE US DAUGHTER COMPANY WITH A 4 PERCENTAGE POINT ADVANTAGE. THIS ADVANTAGE IS INCREASED TO 10 PERCENTAGE POINTS IF, AS THE GERMANS INSIST IS GENERALLY THE CASE, THE US DAUGHTER MANAGES TO AVOID THE ADDITIONAL 10 PERCENT WITHHOLDING TAX ON REPATRIATED EARNINGS SUBSEQUENTLY REINVESTED IN THE FEDERAL REPUBLIC. OFFERGELD ARGUES THAT THIS IS NOT ACCEPTABLE TO THE FRG.

14. THE SITUATION IS, HOWEVER, RADICALLY DIFFERENT IN THE CASE OF DISTRIBUTED EARNINGS. UNDER THE PROPOSED NEW CORPORATE INCOME TAX THE ONLY TAX PAID BY A GERMAN COMPANY ON DISTRIBUTED EARNINGS WHICH IS NOT SUBSEQUENTLY REFUNDED OR CREDITED AGAINST SHAREHOLDERS PERSONAL INCOME TAXES IS THE 13 PERCENT TRADE TAX.

15. THE US DAUGHTER, ON THE OTHER HAND, WOULD BE SUBJECT TO THE FOLLOWING TAXES ON DM 100 OF DISTRIBUTED EARNINGS: THE 13 PERCENT (DM 13) GERMAN TRADE TAX, LEAVING DM 87 SUBJECT TO THE 36 PERCENT (DM 31) GERMAN LIMITED OFFICIAL USE

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PAGE 03 BONN 03841 03 OF 04 071503Z

CORPORATE INCOME TAX ON DISTRIBUTED EARNINGS, LEAVING DM 56 SUBJECT TO THE 15 PERCENT (DM 8) WITHHOLDING TAX. TOTAL GERMAN TAXES THUS WOULD AMOUNT TO DM 52. NO ADDITIONAL US TAX WOULD BE DUE AND DM 48 COULD BE DISTRIBUTED TO THE SHAREHOLDERS OF THE US PARENT COMPANY AS COMPARED TO DM 87 OF PROFITS AND TAX CREDITS WHICH WOULD BE DISTRIBUTED TO THE SHAREHOLDERS OF A GERMAN COMPANY.

16. THIS MASSIVE DISADVANTAGE OF THE US DAUGHTER IN THE GERMAN TAXATION OF DISTRIBUTED EARNINGS WOULD BE FURTHER INCREASED BY 6 PERCENTAGE POINTS IF THE US WOULD AGREE TO THE DROPPING OF THE SPECIAL 15 PERCENT WITHHOLDING TAX PROVISION FROM THE US/GERMAN DOUBLE TAXATION CONVENTION.

#### D. CONCLUSION

17. FROM THE POINT OF US COMPANIES THE PROPOSED GERMAN CORPORATE TAX REFORM AMOUNTS TO A SIGNIFICANT INCREASE IN TAXATION. THEIR TOTAL (GERMAN AND US) TAXES ON REINVESTED PROFITS WILL GO UP FROM THE PRESENT 50 T

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PAGE 01 BONN 03841 04 OF 04 071505Z

47

ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 TRSE-00 XMB-02 OPIC-03 SP-02 CIEP-01

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H-02 PA-01 PRS-01 USIA-06 /083 W

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R 071440Z MAR 75

FM AMEMBASSY BONN

TO SECSTATE WASHDC 8535

LIMITED OFFICIAL USE SECTION 04 OF 04 BONN 03841

PERCENT TO A NEW 58 PERCENT (OR FROM 48 TO 52 PERCENT IF ONE ASSUMES THAT THE COMPANY AVOIDS THE ADDITIONAL 10 PERCENT GERMAN TAX ON REPATRIATED AND SUBSEQUENTLY REINVESTED EARNINGS). THE TOTAL TAXES OF THE US DAUGHTER ON DISTRIBUTED EARNINGS WOULD GO UP FROM A PRESENT 48 TO A NEW 52 PERCENT OR EVEN TO 58 PERCENT IF THE SPECIAL 15 PERCENT WITHHOLDING RATE WERE DROPPED FROM THE US/GERMAN DOUBLE TAXATION CONVENTION.

18. TOTAL TAXATION OF GERMAN COMPANIES PROBABLY WOULD NOT GO UP UNDER THE PROPOSED LAW. THE 4 PERCENT-AGE POINT INCREASE IN THE TAXATION OF RETAINED EARNINGS IN MOST CASES WOULD BE MORE THAN OFFSET BY THE 20 PERCENTAGE POINT DECREASE IN THE TAXATION OF DISTRIBUTED PROFITS.

19. THE GERMAN GOVERNMENT ARGUES THAT THIS RELATIVE INCREASE IN THE TAXATION OF US DAUGHTER COMPANIES IS JUSTIFIED TO RECTIFY A PREVIOUS UNDER-TAXATION OF SUCH COMPANIES AS COMPARED WITH THEIR GERMAN COMPETITORS.

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PAGE 02 BONN 03841 04 OF 04 071505Z

AS WE HAVE INDICATED IN SECTION B, US DAUGHTER COMPANIES IN GERMANY ARE PRESENTLY TAXED LESS HEAVILY ON REINVESTED EARNINGS THAN GERMAN COMPANIES, BUT MORE HEAVILY ON DISTRIBUTED PROFITS. WHETHER OVERALL THEY ARE TAXED MORE OR LESS HEAVILY THAN GERMAN COMPANIES DEPENDS ON THE PERCENTAGES OF PROFITS RETAINED AND DISTRIBUTED.

20. UNDER THE PROPOSED NEW LEGISLATION, THE RELATIVELY HEAVIER TAXATION OF US DAUGHTER COMPANIES ON DISTRIBUTED EARNINGS WOULD BE SUBSTANTIALLY INCREASED AND THEIR TAX ADVANTAGE OVER GERMAN COMPANIES ON RETAINED EARNINGS REDUCED. WHETHER OR NOT THE US DAUGHTER OR THE GERMAN COMPANY IS MORE HEAVILY TAXED STILL DEPENDS ON THE PERCENTAGES OF EARNINGS RETAINED AND DISTRIBUTED. BUT UNLESS CONSIDERABLY MORE THAN 75 PERCENT OF EARNINGS ARE RETAINED, THE GERMAN COMPANY WOULD BE LESS HEAVILY TAXED.

21. IT IS DIFFICULT TO SEE WHY UNDER THESE CIRCUMSTANCES THE US SHOULD AGREE TO DROPPING THE 15 PERCENT LIMITATION ON GERMAN TAXATION OF REPATRIATED EARNINGS OF US DAUGHTER COMPANIES UNLESS WE HAVE REASONS FOR DOING SO UNCONNECTED WITH THE GERMAN CORPORATE TAX REFORM.

22. WE HAVE CONCENTRATED IN THIS MESSAGE ON THE PROBLEMS OF AMERICAN DAUGHTER COMPANIES. A FULL APPRAISAL OF THE GERMAN CORPORATE TAX REFORM ALSO INVOLVES, OF COURSE, THE HEAVIER TAXATION OF INDIVIDUAL FOREIGN SHAREHOLDERS IN GERMAN COMPANIES AND THE INDUCEMENT FOR GERMAN INVESTORS TO INVEST IN GERMAN COMPANIES RATHER THAN ABROAD. FINALLY THE GERMAN TAX REFORM ALSO INVOLVES A SHIFT OF SOME TAX REVENUES FROM THE US TREASURY TO THE GERMAN FINANCE ADMINISTRATION SINCE THE HEAVIER GERMAN TAXES ON US COMPANIES IN GERMANY AND ON INDIVIDUAL US SHAREHOLDERS OF GERMAN COMPANIES WILL MEAN HIGHER US TAX CREDITS AND LESS US TAX PAYMENTS BY THESE COMPANIES AND SHAREHOLDERS.

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PAGE 03 BONN 03841 04 OF 04 071505Z

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